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Before the
Federal Communications Commission
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

In the Matter of	)	
	)	
Implementation of the Telecommunications Act of 1996:	)	
	)	CC Docket No. 96-150
Accounting Safeguards Under the Telecommunications Act of 1996	)	
	)	

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COMMENTS OF BELL ATLANTIC

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August 26, 1996

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COMMENTS OF BELL ATLANTIC[1]

I. Introduction and Summary

The Telecommunications Act of 1996 authorizes the Bell operating companies ("BOCs") to enter several new markets and sets the ground rules for their participation in existing markets. In some instances, the BOCs will need, for a time, to establish separate affiliates, while other services may be offered on an unseparated basis. In this proceeding, the Commission seeks comments on what accounting and cost allocation rules it should adopt to implement the separation requirements of the Act.[2] In particular, the Commission asks for comments on what cost allocation rules, if any, are needed to prevent cross-subsidization of unregulated services by the BOCs' traditional regulated offerings.[3]

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[1] The Bell Atlantic telephone companies ("Bell Atlantic") are Bell Atlantic-Delaware, Inc.; Bell Atlantic-Maryland, Inc.; Bell Atlantic-New Jersey, Inc.; Bell Atlantic-Pennsylvania, Inc.; Bell Atlantic-Virginia, Inc.; Bell Atlantic-Washington, D.C., Inc.; and Bell Atlantic-West Virginia, Inc.

[2] ***See Notice of Proposed Rulemaking***, FCC 96-309 (rel. July 18, 1996) ("Notice").

[3] ***See id.*** at ¶ 12.

Rather than imposing or retaining detailed accounting requirements, this proceeding presents the Commission with the opportunity to streamline its existing cost accounting rules, reduce regulatory burdens, and implement the deregulatory mandates of the 1996 Act. Numerous economists, including the Commission's own Chief Economist, have shown that cost allocation rules are unnecessary to prevent cross-subsidization in a "pure" price cap environment in which prices are not tied to costs. Bell Atlantic and many other large local exchange carriers ("LECs") currently operate under such an environment, and the Commission has signaled its desire to adopt pure price caps for other LECs.

If the Commission does not fully eliminate cost allocation requirements, it should at least streamline the existing rules. Statutory requirements for "arms-length," auditable transactions can be met without imposing yet another layer of regulation on the BOCs or providing a disincentive for innovation by requiring "exogenous" cost changes, as the Commission proposes. Instead of adopting sweeping, burdensome provisions that will ultimately deprive consumers the full benefits of competition by again placing the BOCs at a competitive disadvantage vis-à-vis its large competitors, such as AT&T and MCI, the Commission should deal with any individual problems that should arise on an ad hoc basis through an expedited complaint procedure.

II. Cost Allocations Are Unnecessary Under Price Caps.

A. *Pure Price Cap Regulation Removes the Ability and Incentive to Cross-Subsidize.*

This Notice proposes to implement the accounting safeguard provisions of Section 260 and 271 through 276 of the 1996 Act by adopting accounting and affiliate transaction rules "to achieve our twin goals of protecting subscribers to BOCs' and other incumbent local exchange carriers' regulated telecommunications services against improper cost allocations and competitors against unreasonable discrimination."[4] Carriers subject to "pure" price caps, however, have no incentive or ability to misallocate costs, because any such misallocation could have no effect on regulated rates. Therefore, even the existing affiliate transaction rules are unnecessary to satisfy the Commission's goals. Instead, pure price cap arrangements will fully protect both subscribers and competitors.

This concept is nothing new. The Commission has already found that, under pure price caps, rates are not tied to costs, and the assignment of costs to a given service has no effect on the price that a company charges for that service. When it prescribed pure price caps for AT&T, the Commission found that, "[s]ince AT&T's price caps are unrelated to AT&T's current costs, attempts by AT&T to manipulate the costs it records for affiliate transactions will not increase AT&T's rates."[5] Even in this proceeding, the Commission acknowledges that "[u]nder

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[4] ***Id.*** at ¶ 11.

[5] ***Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions Between Carriers and their Non-Regulated Affiliates***, 8 FCC Rcd 8071, ¶ 101 (1993) ("Affiliate Transaction Notice").

pure price cap regulation, there would be few incentives to subsidize nonregulated services with revenues from regulated telecommunications services and the need for accounting safeguards to ensure against subsidies would be greatly diminished."[6]

Numerous economists concur that cost allocation and accounting provisions are unnecessary in a pure price cap environment. As Professor Alfred Kahn has previously explained, a BOC regulated under price caps "is no more able to cross-subsidize than an unregulated firm."[7] Dr. Robert Crandall has similarly declared that "[w]ith price caps, cost-shifting is no longer a possibility since prices cannot be affected by any manipulation of cost accounts."[8] Likewise, Dr. Laurits Christensen has recently concluded that "[i]n a price cap regime without sharing, cost allocations or changes in cost allocations have no effect on prices."[9]

The Commission's own Chief Economist, Dr. Joseph Farrell, declared more broadly at a May 21, 1996 Brookings Institution symposium that telecommunications pricing is a "mess" because many costs cannot reasonably be allocated to any particular service. Therefore, he urged regulators to "stop trying to allocate costs."[10]

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[6] Notice at ¶ 121.

[7] ***Price Cap Performance Review for Local Exchange Carriers***, CC Docket No. 94-1, Reply Comments of Bell Atlantic, Affidavit of Alfred E. Kahn, ¶ 27 (filed June 29, 1994).

[8] ***Bell Operating Company Provision of Out-of-Region Interstate, Interexchange Services***, CC Docket No. 96-21, Bell Atlantic Comments, Affidavit of Robert W. Crandall, ¶ 8 (filed Mar. 13, 1996).

[9] Dr. Laurits R. Christensen, Treatment of LEC Investments in Joint-Use Broadband Facilities Under a Price Cap Regime at 2, United States Telephone Association Ex Parte filing in CC Docket Nos. 96-112 and 94-1 (filed July 17, 1996).

[10] Communications Daily at 2 (May 22, 1996). Dr. Farrell made clear that he was speaking for himself, not the Commission.

Despite this extensive authority, and findings in this and earlier proceedings, the Notice still proposes to retain the Part 32 and 64 cost allocation rules for affiliate transactions, citing the BOCs' current high market share for exchange service and exchange access.[11] As pointed out two sentences later, however, cost allocations are unnecessary under a pure price cap regime that includes no rate of return regulation, no sharing, and no "entitlement to any revenues [that] may be affected by the costs that it classifies as regulated."[12] Moreover, contrary to speculation in the Notice, the vague possibility that price cap rules "may be adjusted in the future,"[13] is far too remote for any rational company to shift additional costs to their regulated services in the hope that their price caps might be slightly raised in the future, and that they could thereby recoup some small part of the additional costs. It is also a thin reed on which to base retention of a burdensome set of cost allocation and accounting rules.

Nor, contrary to the suggestion in the Notice, does Section 254(k) of the 1996 Act[14] require cost allocation rules.[15] That section only requires the Commission to adopt "any necessary" cost allocation rules to ensure that services included within the definition of universal service bear no more than a reasonable share of joint and common costs. Price cap regulation accomplishes this goal by assuring that common costs, however allocated, cannot impact prices.

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[11] Notice at ¶ 6.

[12] ***Id.***

[13] ***Id.***

[14] 47 U.S.C. § 254(k).

[15] ***See*** Notice at ¶¶ 90 and 125.

Accordingly, for price cap companies, no additional rules are "necessary" to implement this subsection.

B. *Detailed Affiliate Transaction Rules Are Inconsistent With Congressional Intent, and Any Commission Rules Should Be Limited To a Set of Accounting Principles Consistent With the Act.*

Detailed cost allocation rules are not only unnecessary, they are contrary to Congressional intent in enacting the 1996 Telecommunications Act. The purpose of this landmark legislation is "to provide for a pro-competitive, de-regulatory national policy framework."[16] Yet the Notice not only proposes to retain the existing rules, which are not needed; as shown below, it actually it proposes to increase the one-sided regulatory burden created by its existing rules in ways that will undermine meaningful competition. Instead of adopting additional unnecessary regulations here, the Commission should limit any new rules to a set of accounting principles, as contemplated in Section 272(c)(2).[17] Bell Atlantic suggests that the Commission adopt the following principles in lieu of intrusive accounting rules:

> 1. Transactions between a BOC and a separate affiliate established under either Section 272 or 274 must be journalized on the books of both the BOC and the affiliate.
>
> 2. Those entries must be made in accordance with generally accepted accounting principles
>
> 3. The Commission will rely on the audits and complaint processes specified in the Communications Act to insure compliance with the arm's length and nondiscrimination requirements of the statute.

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[16] H.R. Conf. Rep. No. 104-458, 104th Cong., 2d Sess. at 113 (1996) ("Conference Report").

[17] 47 U.S.C. § 272(c)(2).

> 4. Transactions between two or more unregulated affiliates, or between nondominant regulated and unregulated activities in the same affiliate, will not be subjected to any affiliate transaction regulation.[18]

These straightforward principles will give full effect to the provisions of the Act and ensure the Commission's objectives are met. Moreover, it will do so in a way that avoids creating asymmetric regulatory burdens that impede true competition. Beyond adopting these principles, as Professor Kahn recently wrote, "[t]he FCC should simply get out of the way and leave the decisions to investors and consumers. The commission should call off its cost-allocation rule making, leave the prices of unregulated services where they are and let the market work."[19]

C. *There Is No Justification For Imposing Additional Affiliate Transaction Burdens.*

The proposal in the Notice is not just limited to retaining the existing rules. Instead, it proposes to add significantly to the regulatory burden by requiring a BOC to calculate the "fair market value" of all transactions between a BOC and its unregulated affiliate that are

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[18] Bell Atlantic endorses the proposed rules to implement the affiliate transaction principles that are included in the comments of the United States Telephone Association in this proceeding.

[19] Alfred E. Kahn, "Ask Not the Bells for Tolls," ***Wall Street Journal***, August 6, 1996 ("Kahn Article").

not governed by a tariffed rate.[20] This proposal is a variant of one which was first proposed in 1993[21] and was then opposed by a majority of the parties. It should not be adopted now.

The fair market value provision would supplant the current rule for affiliate transactions that uses the prevailing market price, if any, at which the BOC (or its affiliate) has actually sold its own products and non-tariffed services to unaffiliated customers -- a value that is fairly easily ascertained. If there is no such market price, the product or service would be valued at fully distributed cost. Under the fair market value proposal, the BOC or its affiliate would be required to determine in all cases the current fair market value in the unregulated marketplace for each good or service, even where there have been no applicable transactions, for comparison with fully distributed costs. This latter standard would require the BOCs or their affiliates to pore over advertising literature, visit retail outlets, and poll suppliers and customers alike to value every non-tariffed affiliate transaction.[22] It would also be an open invitation to allegations that the valuations were in error. The resulting complaints could place a substantial burden on the Commission resources.

A fair market value calculation is not required to meet the statutory requirement that transactions with affiliates be conducted at arm's length, as claimed in the Notice.[23] The

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[20] Transactions from the carrier to the nonregulated affiliate would be recorded at the higher of fair market value or fully distributed costs, while transactions from the nonregulated affiliate to the carrier would be recorded at the lower of the two costs. Notice at ¶ 82.

[21] ***See*** Affiliate Transaction Notice.

[22] When the Commission first issued this proposal, it included some forty-one paragraphs of detailed proposed instructions. ***Id.*** at ¶¶ 40-81.

[23] Notice at ¶ 78, citing 47 U.S.C. § 272(b)(5).

existing prevailing market price standard already meets that statutory requirement, because it is based upon the price paid to the BOC or its affiliate by unrelated parties for the good or service, operating at arm's length from the seller. If there is no such prevailing market price, the transaction is valued at fully distributed costs, an objective measure that over-assigns costs to the affiliate. Moreover, as shown above, under pure price caps, the BOC would have no ability or incentive to subsidize its non-regulated affiliate with revenues from regulated services. The statute does not require intrusive regulations to define or police all affiliate transactions to assure that they are conducted at arm's length if, as is the case, other less burdensome requirements provide that assurance. As Bell Atlantic pointed out in response to the Affiliate Transaction Notice, this proposal is overly regulatory, inconsistent with a competitive marketplace, and unnecessary in a price cap environment.[24] At least for BOCs that have adopted pure price caps, the proposal should be discarded.

III. Audits Should Be Limited To Those Specified in the Act.

With the elimination of detailed cost allocation and affiliate transaction rules for pure price cap companies, the Commission also should remove its existing requirement for an annual independent audit of each applicable LEC's compliance with those rules.[25] The statute already provides for a biennial joint federal/state audit by an independent firm to determine

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[24] *See* Comments of the Bell Atlantic Telephone Companies (filed Dec. 10, 1993), Reply Comments of the Bell Atlantic Telephone Companies (filed Jan. 10, 1994).

[25] 47 C.F.R. §64.904.

whether the BOC has complied with the separate accounting provision of Section 272,[26] and an annual compliance review under the electronic publishing provisions of Section 274.[27] Additional independent audit requirements would be unnecessary, redundant, and burdensome. In regard to the statutory audits, the Commission should specify that the independent auditor should follow standards established by the American Institute of Certified Public Accountants to conduct the procedures audit, and that those standards also be used by the audit firm to prepare the firm's opinion document.[28]

IV. Exogenous Changes Should Not Be Required For Pure Price Cap Companies.

The Notice suggests that reallocations of embedded investment from regulated activities to nonregulated telemessaging services should be given exogenous treatment for price cap purposes.[29] It also suggests that changes in the relative use of new investment that is jointly used to provide regulated services and non-regulated telemessaging services should likewise result in exogenous changes.[30] Either of these findings would be inconsistent with both Congressional and Commission policy.

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[26] 47 U.S.C. § 272(d).

[27] 47 U.S.C. § 274(b)(8). Transactions between a BOC and an electronic publishing affiliate or joint venture must be carried out in a manner that is auditable. 47 U.S.C. § 274(b)(3)(C).

[28] ***See*** Notice at ¶¶ 93 and 106.

[29] ***Id.*** at ¶ 123.

[30] ***Id.***

First, with respect to new investments, there is no justification for any exogenous treatment of changes in the relative use of new investment. To begin with, the cost of new investment is not reflected in the price caps for regulated services, so that there are no costs to be removed through an exogenous change. Moreover, the theory of price caps was to provide local exchange carriers with incentives to make efficient investments by providing that regulated prices would neither increase or decrease as a result of new investment. As a result, requiring exogenous cost reductions for new investment here is contrary to common sense and to the Commission's own price cap rules.

Second, with respect to new and existing investments alike, such an approach would result in double-counting of the cost of the network investment. The telemessaging service is required to take underlying basic services at tariffed rates. Those rates will fully reimburse the regulated BOC for the actual amount that telemessaging services use the network facilities. There is no justification for counting the network investment a second time by requiring an exogenous cost change to reduce prices for regulated services. Under these circumstances, to put it another way, the BOC would pay twice for the same thing -- once when the telemessaging service pays the tariffed charge and again when the BOC is required to reduce its rate caps.

If the Commission is attempting to give ratepayers a benefit from any economies of scope realized from joint use of network plant, the price cap rules do that already. Under those rules, as well as under the United States Telephone Association's proposal in the pending price cap review proceeding,[31] the productivity off-set is and would continue to be based on a

[31] ***Price Cap Performance Review for Local Exchange Carriers***, CC Docket No. 94-1, Comments of USTA (filed Jan. 16, 1996).

total factor productivity study calculated on a total company basis. Economies of scope realized by integrated telemessaging services are reflected in the offset being higher than it would have been in the absence of such economies. This formula already accomplishes the Commission's goal of giving ratepayers a benefit from increased economies of scope without the use of exogenous changes.

Finally, penalizing the BOCs in this way is contrary to the directives of the 1996 Act. A principal goal of that Act is to "to provide for a pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans."[32] Likewise, the Commission intended that price cap regulation would create "incentives for LECs to invest efficiently in new facilities and to offer innovative services."[33] Under the proposal in the Notice, however, if a BOC developed innovative new telemessaging services that increased the relative use of existing network plant for telemessaging services, it would be required to make an exogenous downward adjustment to regulated rates, thereby reducing its revenues. If the BOC expects to be penalized for developing new, innovative telemessaging services, it would have no incentive to invest in such services. As Professor Kahn recently pointed out, "[i]nvestors in these new services ought to bear the entire additional costs themselves -- but they must also be assured that they will reap the full benefits."[34]

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[32] Conference Report at 113.

[33] ***Price Cap Performance Review for Local Exchange Carriers***, 10 FCC Rcd 8961, 8965 (1995).

[34] Kahn Article.

V. The BOCs' Separate Affiliates Should Be Subject To Minimal Regulation.

A. Any Prescribed Manner of Keeping the Affiliate's Books, Accounts, and Records Should be Based On GAAP.

Section 272(b)(2) of the Act requires separate affiliates required under that section to maintain separate books, records and accounts in the manner the Commission prescribes.[35] The Notice asks whether to prescribe use of generally accepted accounting principles ("GAAP") or some other accounting method.[36] The Commission should find that it need not prescribe any particular accounting method to ensure that the arm's length requirements of the statute are met, because price caps will ensure that no cross-subsidy can occur. If it does prescribe a methodology, however, Bell Atlantic urges the Commission to specify that affiliates should keep their books, records and accounts in accordance with GAAP. GAAP standards are widely established in the accounting industry and the principles are universally understood and followed. Use of GAAP, coupled with the required recording of all transactions with the BOCs, will help auditors to verify those transactions during the biennial audit required by the Act.[37] Use of GAAP, rather than a more burdensome accounting system, will also better enable the separate affiliates, which will be new entrants in highly competitive markets, to compete with incumbents that are unencumbered by Commission-prescribed accounting requirements.

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[35] 47 U.S.C. § 272(b)(2).

[36] Notice at ¶ 68.

[37] 47 U.S.C. § 272(d).

B. *The Commission Should Not Regulate Transactions Within or Among Affiliates.*

Nor should the Commission impose any affiliate transaction or other regulatory requirements to govern transactions between or within their separate affiliates, as the Notice suggests.[38] First, as a legal matter, Section 272 does not give the Commission any authority to regulate such transactions. That section authorizes the Commission to regulate transactions between a BOC (defined in 47 U.S.C. § 153(4) as the existing exchange carriers named therein and their assigns) and the separate affiliates required under that section. It does not authorize the Commission to regulate transactions that do not involve the BOC.

Second, from a policy perspective, it makes no sense to regulate these transactions. The BOCs are entering the interLATA marketplace with no customers and no market share, competing against the likes of AT&T, MCI, and Sprint. The BOCs will have neither the incentive nor opportunity to subsidize unregulated services with interLATA services within the same affiliate. Any attempt to do so would place their interLATA service at an immediate price disadvantage and would quickly negate any attempt at cross-subsidy.[39]

Finally, there is no reason or justification to prescribe yet another cost allocation category, as suggested in the Notice, that would include out-of-region interLATA services and

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[38] Notice at ¶¶ 90 and 97.

[39] For the same reasons, the Commission cannot and should not attempt to regulate transactions between a Section 272 separate affiliate and another affiliate engaging in standards-setting under Section 273. Neither entity is a BOC, and the Commission has no statutory basis for imposing any regulatory requirements on transactions between that entity and the Section 272 affiliate.

incidental interLATA services that are integrated within the BOC.[40] Creating another category is unnecessary to prevent cross-subsidization, because, as shown above, under pure price caps, prices are not related to costs, and any misallocation of costs would have no effect on rates.[41] Moreover, such a change would require the BOCs to revise their applicable systems to allocate all their costs among three categories rather than the current two. Nothing in the Act requires another layer of regulation for such operations, and an unnecessary additional category is inconsistent with the deregulatory nature of the statute.

C. *The Commission Cannot Impute To Regulated Services Any Economies of Scope Enjoyed By Separate Affiliates.*

There is no justification for depriving the BOCs' separate affiliates of any economies of scope they might realize from integrating manufacturing, interLATA long distance, and interLATA information services into the same entity.[42] As an initial matter, the Commission has already found that structural separation will reduce any economies of scope that the BOCs would otherwise enjoy.[43] To the extent such economies can still be gained, however, nothing in the 1996 Act requires or permits the Commission to force the new affiliate to subsidize unseparated regulated services. The concept of a separate affiliate is to permit arm's-length,

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[40] Notice at ¶ 39.

[41] Existing Part 36 and 69 Rules already allocate the interstate portion of such costs. This is an independent reason why a separate accounting category is unnecessary.

[42] ***See*** Notice at ¶ 70.

[43] ***Id.*** at ¶ 10.

independent operation, not to be a conduit for subsidies to regulated services. To the contrary, the Act directs the Commission to eliminate implicit subsidies to local service, not to create new ones.[44] The separate affiliate, like any other business, should have incentive and ability to operate in the most efficient manner, without the threat that they will need to disgorge any resultant savings to regulated ratepayers.

VI. Imputation of Access Charges Is a Pricing, Not an Accounting, Issue.

The Notice points out that the 1996 Act requires the BOCs to impute access charges to their own services at a rate that is no less than the rates charged to others in connection with comparable services[45] and asks for comments on the proper accounting treatment of such imputed charges. The issue of imputed charges relates to the pricing of services, however, and is not an accounting issue. In fact, the Commission has long required the BOCs to impute access charges in connection with rates for corridor service, but it has imposed no accounting requirement.[46] None is justified here.

If the Commission were to impose some type of accounting requirement, however, the proposal in the Notice would inflate the BOC's financial statement. As the Commission has previously held, a "debit to nonregulated revenues is necessary in order to

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[44] ***See*** 47 U.S.C. § 254(e)

[45] Notice at ¶ 41, citing 47 U.S.C. § 272(e)(3).

[46] ***See Application of Access Charges to the Origination and Termination of Interstate IntraLATA and Corridor Services, Memorandum Opinion and Order,*** FCC 85-172, 57 R.R.2d 1558, ¶ 9 (1985).

prevent overstatement of total company revenues."[47] The proposal in the Notice, however, would require a debit to expenses, not revenues. If the Commission were to impose accounting for imputed access charges, which it should not, it should debit the revenues of the service using the access, not the expenses, and credit access revenues.

VII. Making Written Information Concerning Transactions Available For Inspection Does Not Require Internet Access.

Pursuant to Section 271(b)(5), transactions between a BOC and its affiliates must be reduced to writing, and those writings must be available for public inspection.[48] The Notice asks whether Internet posting is needed to comply with the "public inspection" requirement.[49] Such posting is not needed. A BOC may comply with this provision by designating a public office where the written transaction documents may be inspected.[50]

[47] ***Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities***, 3 FCC Rcd 6701, 6709 n.15 (1988).

[48] 47 U.S.C. § 272(b)(5).

[49] Notice at ¶ 74. A similar provision for transactions with electronic publishing affiliates appears at 47 U.S.C. § 274(b)(3)(B).

[50] Any confidential or proprietary material would be available only to parties that sign non-disclosure agreements.

VIII. Conclusion

The 1996 Act was designed to be pro-competitive and deregulatory. The accounting measures to implement the Act should both lessen the regulatory burden on all affected carriers and avoid imposing any requirements that tend to skew the competitive marketplace. To further these statutory mandates, the Commission should adopt the principles and proposals set out above.

Respectfully Submitted,

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August 26, 1996

CERTIFICATE OF SERVICE

I hereby certify that on this 26th day of August, 1996 a copy of the foregoing "Comments of Bell Atlantic" was sent by first class mail, postage prepaid, to the parties on the attached list.

Jonathan R. Shipler

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